



## Agenda Item 4a

December 13, 2011

**TO: MEMBERS OF THE BENEFITS AND PROGRAM ADMINISTRATION COMMITTEE**

- I. SUBJECT:** Proposed Regulations Regarding Personal Trading Regulation
- II. PROGRAM:** Enterprise Compliance
- III. RECOMMENDATION:** Staff recommends Board approval of the proposed regulatory language (Attachment A) and initiation of the rulemaking process to add Section 558.1 to Title 2 of the California Code of Regulations to establish requirements for personal trading.

**IV. ANALYSIS:**

As fiduciaries, CalPERS Board members and staff owe paramount loyalty to CalPERS members and beneficiaries and have a duty to place the interests of those members and beneficiaries first. State law prohibits CalPERS Board members and staff from using confidential information available to them by virtue of their employment or position on the Board for private gain or advantage. CalPERS employees and Board members may come into possession of, or have access to, material non-public information and have a duty to safeguard this information and to not disclose it. The anti-fraud provisions of the federal securities laws generally prohibit persons who have a duty not to disclose material non-public information from trading securities based on such information. Persons who violate these rules are subject to potential civil damages and criminal penalties. Current industry best practices necessitate the implementation of policies and procedures to ensure that the personal trading activities of employees are reported, monitored, and in some instances, preapproved.

In 2008, CalPERS briefly implemented a personal trading policy. However, due to the absence of regulatory backing for the policy and opposition from staff, the policy was suspended after less than a year. Staff nonetheless firmly believes that a personal trading policy and regulation are critical in order to ensure full compliance with SEC rules and to align with industry best practices. Accordingly, the Office of Compliance Office has worked with staff from the Investment Office, the Legal Office and the Human Resources Division to develop a revised personal trading policy and a proposed regulation that will codify the policy.

Drawing upon lessons learned in 2008, the policy and regulation were developed using a participative approach, soliciting feedback from a broad range of covered employees. The personal trading policies of other pension funds and brokerages were examined and many elements were referenced to assure adherence to current industry best practices. In addition, staff has developed a comprehensive communication plan to ensure that all affected employees, labor groups, and legislative staff are kept informed and involved in the process. Opportunities for additional feedback will be available through the rulemaking process. Throughout the development of the policy and regulation, staff has had strong support from CalPERS leadership and throughout the enterprise.

The proposed regulation codifies the policy and outlines the procedures and limitations that govern transactions in securities by covered employees and Board members. Key provisions of the regulation identify the persons, accounts, securities and transactions that are covered and describe the pre-trade approval process, the trading restrictions, the reconsideration process and the reporting requirements.

Approval of the proposed regulation will:

- Ensure compliance with applicable laws and regulations governing personal securities trading;
- Help prevent insider trading, front running, and conflicts of interest;
- Protect staff and Board members from inadvertently violating securities laws and entering into potential conflicts of interest;
- Ensure CalPERS employees and Board members are meeting their fiduciary duty;
- Reinforce CalPERS reputation for integrity by avoiding even the appearance of impropriety;
- Enable the organization to provide an effective platform to monitor trading activity of key personnel; and
- Provide employees and Board members with easy 24/7 access to clear trades.

The proposed Notice of Regulatory Action, which contains the text of the proposed regulation, is attached as Attachment A.

If Board approval is received, the following regulation process is planned:

- Publication of the Notice of Proposed Regulatory Action in the California Regulatory Notice Register;
- A minimum 45 day public written comment period;
- A public hearing, if requested, by a member of the public;
- Final Board approval to adopt the proposed regulations; and

- Transmission to the Office of Administrative Law for filing with the Secretary of State and publication in the California Code of Regulations.

If no changes are made to the regulation during the public comment period, Section 558.1 could become effective 30 days after filing with the Secretary of State.

## **V. RISKS:**

Changes to CalPERS regulations inherently involve a high degree of risk. Approval of the regulation could potentially result in an adverse impact to recruitment and retention of covered staff, and implementation efforts will require IT support.

If approved, the ability of the regulation to achieve its desired effect could be impacted by several factors, including staff support of the regulation, IT capacity to implement software, and implementation costs. Based on reactions of affected staff in developing the regulation and an initial analysis of monitoring platforms, the Compliance Office believes these risks to be adequately mitigated.

Failure to implement the regulation will constitute a significant weakness in CalPERS internal controls to protect staff and the organization from violations of State and federal securities laws. Inability to monitor personal securities trading could result not only in compliance violations, associated legal impacts, and potential fines, but also in significant harm to CalPERS reputation for integrity and fiduciary responsibility.

Approval of this item is expected to result in a reduction to risk exposures for Policy Compliance, Compliance with Laws and Regulations, and Stakeholder Perception, and possible increases in risk exposure for Human Resources Management and Technology/Systems Management.

## **VI. STRATEGIC PLAN:**

This item supports Objective 3.3 of the 2011-12 Business Plan, which states, "Integrate enterprise risk management into governance structures and culture to effectively evaluate, monitor, and manage risk across the organization."

## **VII. RESULTS/COSTS:**

Costs associated with this item have been allocated as part of the Fiscal Year 2011-12 Budget.

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LARRY JENSEN  
Chief Risk Officer  
Office of Enterprise Risk Management

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RUSSELL G. FONG  
Acting Chief Financial Officer

Attachments